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Ten Tips for Dealing with Bankruptcies Caused by the COVID-19 Shutdown

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Bankruptcies happen. They happen in booming economies as well as in recessionary ones, and they likely will massively occur in the frozen business environment caused by the COVID-19 pandemic. The suddenness of the pandemic's onset is unprecedented. For many, consequently, dealing with those bankruptcies will be an unwanted and unanticipated new experience. Nevertheless, corporate and individual creditors of those prospective — or already-filed — debtors will want to do what they can, when they can, to protect their interests and minimize the damage to their own operations.

This article offers 10 simple tips to help achieve those protections. Your mileage may vary, as the saying goes, but it remains important to buckle your seatbelt.

1. Review your contracts and credit terms.

When a customer enters a Chapter 11 bankruptcy, the automatic stay prevents creditors from commencing or continuing any efforts to collect a debt that relates to the period prior to the bankruptcy filing date. That means that a creditor cannot sue, cannot write demand letters, and cannot verbally demand payment of "pre-petition" accounts receivable. That does not, however, mean that one should do nothing.

First, a creditor would be well-advised to collect and preserve all documents relevant to

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their business relationship with the debtor. These will include contracts, delivery confirmations, bills of lading, credit agreements, and anything else that provides the factual and legal basis for claims against the debtor. Proofs of claim (the formal documents establishing creditors' rights to payment through the bankruptcy process) must provide adequate detail to prove one's claim, and it is never too soon to assemble that support.

Second, because a "debtor-in-possession" will typically continue to operate during its bankruptcy case, creditors must decide whether they wish to continue to do business with a debtor following the filing. Often debtors will reach out to suppliers to secure specific post-petition credit terms, sometimes with the assistance of the creditors committee (see below). That said, each creditor must make their own assessment of the post-petition creditworthiness of the debtor. Many Chapter 11 cases are unsuccessful and "convert" to liquidations under Chapter 7, often leaving those who supplied the debtor post-petition burned twice.

Third, irrespective of whether you're going to do post-petition business with the debtor, file your "proof of claim" in order to avoid being barred from your rightful recovery from the debtor's bankruptcy estate (see discussion below regarding the "bar date").

2. Payments to creditors made within 90 days of the bankruptcy should be protected from clawback as preferential transfers if those payments are made in the ordinary course of business.

One of the most frustrating experiences businesses confront is when they're sued for the recovery of a "voidable preference" by a company that they have supplied, which likely still owes money for goods or services delivered but unpaid, and where little to no recovery is expected on account of their resulting claim. "Preferences" concern (in most basic terms) the right of the debtor (or trustee) to recover payments made to a creditor during the 90-day period prior to the commencement of a bankruptcy case, provided that certain criteria are met and in the absence of bankruptcy-specific defenses.

A preferential transfer is one made of the debtor's property (usually money) on account of an "antecedent debt" (think of a payment of a past-due bill), to or for the benefit of the creditor (look in the mirror), while the debtor was insolvent (a legal "rebuttable presumption" during the 90-day period before the bankruptcy case began), that gave that creditor more than they would have received had the debtor been liquidated on that petition date (a virtually guaranteed fact). The two most viable defenses to a lawsuit seeking to recover a preference will be that the payment was made "in the ordinary course of business" (either between the parties or otherwise within the relevant industry, often expensive to prove), or that the creditor gave "new value" to the debtor (basically meaning you are unpaid for new goods and services delivered after the date you received the preference, subject to certain limitations not relevant here).

The idea behind the preference statute is to bring those payments back into the bankruptcy estate and redistribute them to all creditors on a pro rata basis. One that returns a preferential payment, by statute, is given a general unsecured claim for the amount returned. The means of achieving fairness is not universally viewed as actually fair, either in theory or in practice, but it's how the statute works.

If one is dealing pre-bankruptcy with a customer in financial distress, any change in credit terms may deprive a future preference defendant of the "ordinary course of business" defense. Further, if pressure is used on the customer, and late payment is made afterward, that payment may be similarly deemed "outside" the ordinary course. Some suppliers of companies in trouble will begin to require pre-payment for goods, or request payment of current invoices under standard terms and forego the payment of seriously past-due invoices in order to maintain "regularity" of payment during the period leading up to a bankruptcy filing. These techniques may deprive a plaintiff of successfully asserting that the payment they're seeking to recover is actually on account of an "antecedent debt."

3. In a Chapter 11 case, a goods supplier may qualify for priority payment status above other unsecured creditors under Section 503(b)(9) of the Bankruptcy Code.

Bankruptcy Code Section 503(b)(9) allows trade creditors who have supplied goods to the debtor, in the ordinary course of business, with-

in 20 days before debtor's bankruptcy filing, to assert an "administrative expense" claim for the value of those goods. In this way, 503(b)(9) provides "priority" status to such goods suppliers over other unsecured creditors, thereby increasing their chances of recovering full payment of their claims.

Although priority status under 503(b)(9) is afforded only to trade creditors that supply goods, some courts have extended its priority status to creditors in mixed claim cases, i.e., those that involve both goods and services. The law on this issue is not uniform, however, and it is important to know the applicable law in your particular jurisdiction if your claim involves such mixed transactions.

While granting priority status to suppliers of goods, 503(b)(9) does not require the immediate payment of allowed claims. Bankruptcy courts have discretion in determining whether a vendor is "critical" so as to require immediate payment. This determination is based on various factors, including the prejudice or hardship to the creditor, and the potential hardship to other creditors.

A creditor with a potential 503(b)(9) claim must pay close attention to the bar date notice and any applicable local rules in the jurisdiction where the bankruptcy case is proceeding to determine the procedures for asserting a timely claim.

4. Chapter 11 unsecured creditors may also receive priority payment status if designated "critical vendors." But, while conducting negotiations with the debtor when seeking this designation, avoid potentially punishable conduct that may violate the automatic bankruptcy stay.

Generally, creditors who do not otherwise qualify for priority claim status (either because they provided services rather than goods or provided goods outside the required 20-day pre-bankruptcy period), are relegated to general unsecured creditor status and face the prospect of recovering only a fraction of their claims. These creditors should attempt to be deemed "critical vendors," which would give them the opportunity to recover full payment of their pre-petition claim.

Critical vendors provide goods or services that a debtor considers essential for its survival. If there is no contract between a creditor and the debtor requiring continued creditor performance, that creditor technically is not required to continue doing business with a debtor. In order to prevent the creditor from terminating its business relationship with the debtor once the bankruptcy is underway, a debtor can designate the creditor as "critical" and ask the bankruptcy court for permission to pay that creditor's pre-petition claim in full. This offer usually comes with certain conditions — generally, concessions on post-petition credit terms. Risks to critical vendors, however, may be minimized because their post-petition business dealings with the debtor entitle them to administrative expense status — which means their debts may and should be paid on a regular basis during the course of the bankruptcy case.

Creditors who seek critical vendor status, however, cannot threaten to terminate their business relationship with the debtor unless they receive full payment of their pre-bankruptcy claim. Such threats may be punishable violations of the automatic bankruptcy stay. For this reason, and to avoid inadvertently waiving any rights, consultation with bankruptcy counsel is advised when attempting negotiations with a debtor regarding critical vendor status.

5. Insurance: Are you an "additional named insured" or a "vendor endorsee"?

Debtors come in all shapes and sizes, and so do their creditors. Often, the most important assets of a debtor will be the insurance policies that may provide a secondary resource for creditor recovery. Accordingly, for example, when a supplier goes into bankruptcy, it is important to examine how the business relationship was first established. Is your company an "additional named insured" under the debtor-supplier's general liability coverage? Was such status a condition of your contractual relationship with them? If your company is a distributor of a debtor's products, are you a "vendor endorsee" under the manufacturer's insurance? Of course, if you are a tort claimant with a lawsuit against the debtor and those in its

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distribution chain, the debtor's insurance policies will be of particular interest.

Those interested in a debtor's insurance policies — of whatever sort — must take special care to monitor what is revealed during the bankruptcy, starting on the filing date all the way through to a confirmed reorganization plan. It's not uncommon for a debtor during or even at the outset of a case to negotiate a "policy buy-back" with its insurance company, thus potentially eliminating the independent obligation of the insurance company to pay *your* claim. If such a transaction is presented to the bankruptcy court, on notice to you, and you do nothing, it's likely you'll be bound by the potentially disadvantageous results. In addition, a debtor may seek to settle a claim other than yours that is covered by an insurance policy and has the effect of exhausting (or severely depleting) the funds available under the relevant policy. In all these cases it is imperative to monitor the case, know the status of the debtor's insurance, and file timely objections to anything the debtor does to eviscerate insurance coverage that might be available to satisfy your own claim.

6. Creditors committee: join or sit this one out?

In every Chapter 11 case the largest creditors holding "general unsecured" claims are solicited by the Office of the United States Trustee (a branch of the Department of Justice) to become a member of an official committee of unsecured creditors. If you have the dubious honor of being so approached and offered the opportunity to participate, we generally recommend that clients accept the invitation. There are several reasons for this view. First, the committee acts on behalf of all similarly situated creditors. That is, they are the "voice of the creditors' constituency" and — through committee counsel paid by the debtor — represent the positions of the creditor body on all issues presented to the bankruptcy court. Second, you can guide the case to a businesslike conclusion, and maintain close contact with principals of the debtor. Third, it often provides an opportunity to work with others in your field, build additional business relationships, and gain valuable experience.

It is important to note that one may not use their position on the committee for individual advantage, such as pressuring the debtor for improper payment terms. That said, the experience of serving on a committee can provide business insights not otherwise available. For small businesses, serving on a committee may prove too distracting, take more time than is warranted, and provide diminishing or even negative returns. Other creditors may simply prefer to not "surface" in a bankruptcy case prior to the bar date (when they need to file their claim). Obviously, each creditor must make their own decision, but on balance we typically consider committee membership advantageous.

7. In connection with a debtor's sale of "substantially all" of its assets, determine whether your ongoing contracts or leases are being assigned to third parties about whom you may have cause for concern.

Bankruptcy Code Section 363 enables a debtor to sell some or "substantially all" of its assets during the bankruptcy case. These sales typically are done through a court-approved auction process. Generally, through initial marketing efforts the debtor identifies a "stalking horse" bidder. After executing a tentative asset purchase agreement with the stalking horse, the debtor seeks bankruptcy court approval for the auction, including negotiated bidding procedures. After the auction is held, and the successful bidder selected, the debtor must seek bankruptcy court approval for the sale. Creditors and other parties-in-interest are entitled to object — and the court will consider the interests of all these differing parties in determining whether to approve and finalize the sale.

Under Section 363, the sale of debtor's assets will generally be free and clear of all liens, claims or other encumbrances. Creditors with a security interest in these assets typically transfer their liens to the sale proceeds.

One should note that a 363 sale may allow the debtor to assume and assign to the successful bidder any executory contracts or unexpired leases of the debtor. To do so, the debtor must first "promptly" cure any defaults under such contracts and leases and provide "adequate assurance of future performance" for the benefit of the contract's counterparty (see discussion below regarding curing assumed contracts).

Courts vary on what constitutes a prompt cure. Contractual counterparties should review the debtor's proposed sale filings with great care to determine whether their executory contracts or unexpired leases are being assumed and assigned to a third party with whom they have not previously done business — such as a competitor. If there is a legitimate reason for concern, this should be identified early on and raised in a timely objection before the bankruptcy court.

8. Pay attention to deadlines for filing proofs of claim; this bar date differs depending on the type of case and is often noticed in different ways.

One of the biggest mistakes creditors make is overlooking critical notices at the start of a bankruptcy case, assuming they are junk mail. One of the most crucial notices sets forth a bar date — the deadline to file a proof of claim in the debtor's case. Missing this deadline could severely impact your ability to recover from the debtor's estate.

In virtually all Chapter 7, Chapter 13, and individual Chapter 11 cases, the bankruptcy court generates and sends a notice of bankruptcy. Watch out, because in these cases, the initial notice sets the proof of claim bar date (along with other important deadlines, like the date for the official first meeting of creditors or the deadline to object to an individual debtor's debt "discharge"). The bar date actually is set by Rule 3002(c) of the Bankruptcy Rules: 70 days from the petition date (or the date of conversion, if the case converts to a Chapter 13), with certain exceptions set forth in Rule 3002(c) (1)–(5). A creditor may extend this deadline by motion if the debtor provides insufficient notice by untimely filing the list of creditors' names and addresses or sending it to a foreign address, but only for a period of 60 days.[1]

In corporate Chapter 11 cases, the initial case notice generally will not provide the bar date. Rather, the debtor typically obtains from the court, after notice and hearing, a bar date that sets forth: the proof of claim deadline (note that many bar date orders set two dates — a general bar date and a longer one for governmental entities; don't mix them up!); the manner in which the debtor must provide notice of the bar date; and instructions for filing the proof of claim with the court or a claims agent. The court may extend the bar date, even after it expires, but only upon motion demonstrating "excusable neglect."[2]

That said, BEWARE: Some bankruptcy courts (e.g., District of Utah) automatically set the bar date as 90 days following the first date set for the "official meeting of creditors" and that bar date is shown on the one-page "notice of commencement of bankruptcy case" that is mailed to all creditors. Accordingly, to avoid "missing the bar date," be aware of the applicable local rules and carefully read every notice that you receive from the bankruptcy court.

Rule 3002(a) requires all secured creditors, unsecured creditors and equity security holders (reflecting ownership interests) to file proofs of claim for such claim to be "allowed" and consequently entitled to appropriate treatment in the bankruptcy case. Although in a Chapter 11 reorganization case, Rule 3003(c)(2) provides that only a creditor or equity security holder whose claim is *not* scheduled in the debtor's schedule of assets and liabilities, or which is scheduled as disputed, contingent, or unliquidated, must file a claim in order to vote on a plan and obtain a distribution, it's always advisable to proactively file a claim and not rely on one's status in the debtor's schedules.

9. Search your contracts for "force majeure" clauses, and if they exist, examine their scope and requirements to be ready if your customer seeks to avoid performance.

Many contracts contain "force majeure" clauses, which can excuse a party's performance under that contract in the event of circumstances beyond their control that render performance impracticable or impossible. These circumstances include "acts of God," such as fires, hurricanes or explosions; acts of terrorism or war; acts of governmental authority; and epidemics. Under New York law, for example, mere financial considerations are not circumstances constituting a force majeure event, and at least one case specifically says "financial hardship is not grounds for avoiding performance under a contract."

Make certain to look at the specific language of your contract, because courts interpret force ma-

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jeure clauses narrowly. Performance is excused if the force majeure clause specifically identifies the event that actually prevents a party's performance. Some force majeure clauses specifically include pandemics as an event. Other parties to contracts with force majeure clauses may rely on state executive orders shutting down businesses or instituting lockdowns as events excusing performance. Still, if a contract requires one party to give the other notice of the existence of force majeure conditions, such notice must be given for a party to be excused from its contractual obligations. And such notice often must be provided within a fixed time commencing upon the existence of such circumstances and their effect on the party's inability to perform its obligations. Under New York law, the party relying on a force majeure clause must also attempt to perform its contractual duties despite the event.

Bankruptcy courts will look to state law to determine whether force majeure may allow a debtor to escape its obligations under a contract. One note of caution if you, as a non-debtor, seek to invoke force majeure over an executory contract: At least one court has held that a party's improper declaration of force majeure violated the automatic stay, because the contract was an asset of the estate, and the non-debtor sought to exercise control over the contract and deprive the debtor if its use and value.

10. Disputes regarding cure amounts for contracts assumed in bankruptcy are common, and contractual counterparties must act promptly to protect their interests.

Pursuant to Section 365 of the Bankruptcy Code, a debtor, subject to court approval, can decide whether it wants to assume or reject any of its executory contracts (on which some performance remains to be completed) or unexpired leases regardless of what the contract or lease says about termination. The debtor can assume favorable contracts and assign them to another party — even without the contractual counterparty's consent.

If the debtor rejects a pre-petition executory contract or unexpired lease, it may still be liable to the creditor for some or all of the amount of the contract. Payments are accelerated and deemed due just prior to the petition date, and the creditor under the rejected contract is left with a general unsecured claim for the remaining amounts due. The Bankruptcy Code has a specific limitation on the amount of damages available to a landlord for the rejection of a lease agreement.

If the contract or lease is to be assumed (or assumed and assigned to a third-party purchaser), then the debtor must "promptly" cure any defaults and provide "adequate assurance of future performance," whether by itself or by the party proposed to assign the agreement. This could potentially give rise to a dispute concerning the cure amount due as well as the viability of the party proposed to continue contractual performance. Creditors whose contracts are being assumed should look closely through the debtor's filings, including the notices concerning the assumption of contracts and leases, to determine the amount the debtor proposes to pay to cure any defaults. Sometimes this amount will be listed as zero, left blank, or be a number significantly less than the creditor believes it is owed. Creditors who fail to object to the debtor's cure amount by the deadline listed in the debtor's notice may waive their rights to litigate this issue.

These 10 tips easily could be extended to 20, 30 or more. The bankruptcy process can be confusing to the uninitiated (and even to the initiated) and is full of traps for the unwary. The COVID-19 pandemic has created innumerable challenges to individuals and businesses alike. The bankruptcy courts will be but one venue for resolving those challenges. Here, as elsewhere, knowledge is power, and the more you know, the better the outcome can be.

ENDNOTES

[1] *Bankruptcy Rule 3006(c)(6).*

[2] *Bankruptcy Rule 9006(c).*

About Anderson Kill

Anderson Kill practices law in the areas of Insurance Recovery, Commercial Litigation, Environmental Law, Estates, Trusts and Tax Services, Corporate and Securities, Antitrust, Banking and Lending, Bankruptcy and Restructuring, Real Estate and Construction, Foreign Investment Recovery, Public Law, Government Affairs, Employment and Labor Law, Captive Insurance, Intellectual Property, Corporate Tax, Hospitality, and Health Reform. Recognized nationwide by Chambers USA, and best-known for its work in insurance recovery, the firm represents policyholders only in insurance coverage disputes — with no ties to insurance companies and has no conflicts of interest. Clients include Fortune 1000 companies, small and medium-sized businesses, governmental entities, and nonprofits as well as personal estates. The firm has offices in New York, NY, Stamford, CT, Newark, NJ, Philadelphia, PA, Washington, D.C., Los Angeles, CA and Newton, MA.

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